to stymie competition. The improvement in the odds of success that a shift in the burden of proof would cause will invite such tactics.

The Commission, too, will suffer undue burdens if frivolous complaints are easy to file. Most importantly, the Commission's resources to deal with any non-frivolous complaints will be severely diluted. To minimize the potential for such misuse of the Commission's process, the FCC should continue to require that the proponent of a complaint maintain the burden of proof.

The Commission states that burden-shifting may alleviate some of the discovery difficulties complained of by parties as well as represent an efficient way to resolve complaints invoking the expedited procedures of §271(d)(6). *NPRM*, paras. 101-102. Shifting the burden of proof is unnecessary to deal with these issues. There are other mechanisms to accommodate the statutory 90-day window. For example, the Commission could impose expedited discovery requirements. In addition, the accounting, record keeping, public access, and audit requirements of the 1996 Act[47] make available to would-be complainants a large body of information that would not be available, for example, in the case of a pre-1996 Act discrimination hearing.

Finally, the Commission asks whether the burden of proof might be shifted upon some showing by a complainant of a *prima facie* case of a violation of any of the requirements for interLATA entry. *NPRM*, para. 102. Unlike discrimination cases, where the applicable law is quite straightforward, the criteria for interLATA entry involve a large number of complex, interrelated requirements. Complaints seeking to reverse an interLATA entry authorization cannot be analyzed by the same simplified approach as discrimination cases. The Commission cannot, consistent with its responsibilities to promote competition, ignore some or all of the factors bearing on interLATA entry in order to make it easier to exclude the BOCs from markets they have been allowed to enter. In light of the foregoing, shifting the burden of proof to the defendant BOCs is contrary to Congress's intent, unreasonable, and unwarranted.

B. The Commission Can Construct A Hearing Process That Is Both Expeditious And Fair To All Parties

Section 271(d)(6)(A) provides that if, at any time after approval of a BOC application, the FCC determines that the BOC has ceased to meet any of the conditions of its approval to provide interLATA services, the agency may, after notice and opportunity for a hearing: (1) issue an order to the BOC to correct the deficiency; (2) impose a penalty pursuant to Title V; or (3) suspend and revoke the BOC's approval to provide in-region interLATA services.[48] The Commission seeks comment on the appropriate "notice and opportunity for hearing" for the imposition of the non-forfeiture sanctions. Further, the Commission interprets the phrase "opportunity for a hearing" not to require a trial-type hearing before an Administrative Law Judge. *NPRM*, para. 106.

The Commission can create a prompt hearing mechanism that balances the interests of all parties. It is indisputable that certain claims of violations of §§271 and 272 may not be easily resolvable on a paper record alone. Accordingly, the Commission should provide for the possibility of discovery and an oral evidentiary hearing when justified by the circumstances. (For example, an oral hearing would be necessary if the credibility of witnesses were an issue.) First, this approach affords parties full due process rights by allowing full development of the facts and an opportunity to cross-examine witnesses. Second, a trial-type

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[47] *E.g.*, 1996 Act §§272(b)(2), (5), (c)(2), (d).
[48] *See* 1996 Act §271(d)(6)(A).

hearing is more conducive to resolving the highly technical, complex matters that may be at issue. Finally, with the proper management, this process will allow for speedier resolutions.

To expedite the process and ensure the filing of meritorious suits, the Commission should require the complainant to file more than a bare "notice-type" complaint. For example, the Commission should require the pre-filing of testimony, exhibits, and all other information relevant to support the claim, along with all requests for discovery. The opening case should only be supplemented with new, relevant material obtained through discovery. This approach is reasonable and wholly conducive to resolving the complaint within the required 90-day statutory period.

In addition, the Commission should invoke the "clear and convincing" evidentiary standard. A complainant should be required to prove by clear and convincing evidence that material aspects of the findings made by the Commission in granting an approval under §271 are no longer valid and that the BOC has not corrected such discrepancies within a reasonable period. Any lesser evidentiary standard runs the risk of turning the Commission's process into a surrogate for the competitive arena, where competitors who failed to exclude BOCs from entry in the §271 process can wage battle after battle attempting to remove the BOCs from their market. A rigorous evidentiary standard will help deter such inappropriate filings. More importantly, it will help assure that once competition has been established, it cannot be stopped for trivial reasons with flimsy proof.

C. The Rates And Practices Of Non-Dominant BOCs Should Be Presumed Lawful

The Commission tentatively concludes that, in the context of complaints alleging that a BOC has ceased to meet the conditions required for the provision of in-region interLATA services, it will not employ a presumption of reasonableness in favor of the BOC or BOC affiliate, even when the BOC or affiliate is regulated as a non-dominant carrier. *NPRM*, para. 104. This astonishing conclusion is not justified in the *NPRM*, nor can it be. When a BOC is not considered to be dominant—and, as shown below, it should not be in the interLATA market—it should be treated like other non-dominant carriers -- entitled to a presumption of reasonableness. Anything other than equal treatment works against the principles of fairness and regulatory parity. This topsy-turvy rule, like the burden of proof proposal, will have the effect of promoting "strategic" litigation and of disadvantaging the BOCs in markets that are supposed to be competitive and fair.

Non-dominance, by definition, implies that the BOC has no power to set prices independently of competitive constraints. Congress and the Commission regard such prices as inherently just and reasonable. Thus, the presumption of reasonableness is necessary and entirely justified.

D. The Commission Should Not Adopt Additional Reporting And Regulatory Requirements

The Commission seeks comment on what requirements are necessary to facilitate detection and adjudication of violations of separate affiliate and non-discriminations safeguards. *NPRM,* para. 95. No additional rules and requirements are warranted. First, the disclosure requirements of §272(b)(5) are sufficient to monitor transactions on an on-going basis.[49] Burdensome additional reporting requirements are unnecessary and have not been mandated by Congress. However, reports analogous to those imposed by the Commission's CEI plans or ONA plans under *Computer III* could be considered, if the Commission considers them

[49] *See* 1996 Act §272(b)(5).

necessary, and are preferable to reversing the burden of proof or denying the presumption of reasonableness. Such reports should not be needed, however, because the 1996 Act already provides for comprehensive compliance audits.[50] Accordingly, the Commission should not impose any monitoring requirements more burdensome than those mandated by Congress.

The promulgation of specific regulations to implement the non-discrimination provisions of §§272(c)(1) and (e) is unnecessary. *NPRM,* para. 96. These provisions can be enforced under the Commission's existing nondiscrimination jurisprudence.

Finally, the Commission is correct that §271(d)(6)(A) generally augments the Commission's existing enforcement authority. *NPRM,* para. 97. No new regulations are required other than those contemplated by the Commission to implement the expedited processing.

VIII. The Commission Should Declare The LECs' Affiliates Are Nondominant In The Provision Of Interstate, Interexchange Services (¶¶ 108-152)

In the *NPRM*, the Commission considers whether the BOCs should be regulated as dominant or nondominant carriers with respect to the provision of in-region interstate, interLATA services. *NPRM*, para. 108. The Commission also seeks comment on whether it should also require independent LECs to provide interstate, interexchange services through a separate affiliate as a condition of nondominant regulation. Finally, it considers whether to apply the same regulatory classification to the BOCs' affiliates' and independent LECs' provision of in-region, international services as it will adopt for their provision of in-region, interstate, domestic services.

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[50] *See* 1996 Act §272(d).

This proceeding, in concert with the applications that some BOCs will soon file under §271 of the 1996 Act, presents the Commission with an historic opportunity -- perhaps the greatest opportunity in its history -- to benefit ordinary telecommunications consumers. The reason is the potential for real competition if the BOCs' affiliates are allowed to enter the interLATA market. California consumers would gain even more from new competitive entry than average, because the interLATA market has grown even more profitable, and less competitive, in this State than elsewhere.[51]

But a great deal of the potential consumer benefit from new entry hinges on the outcome of this proceeding. The benefits of entry would be diminished, if not entirely destroyed, by asymmetrical regulation that would erect new price umbrellas and hobble the BOCs' ability to compete with the players that are already well-established in the market. If the suggestion is true that under the Commission's current rules the BOCs' affiliates would be presumed dominant, see *NPRM*, para. 130, then the need for this proceeding is obvious. But the Commission must act

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[51] Prof. Paul MacAvoy recently calculated that price-cost margins on MTS calls in California had increased, by 1994, to 70 percent (that is, for every ten cents in price, three cents was marginal cost, seven cents profit). For WATS switched inbound, 70 percent; for WATS switched outbound, 75 percent. Paul W. MacAvoy, *The Failure of Antitrust and Regulation to Create Competition in Long-Distance Telephone Services* (MIT Press, 1996), pp. 120-23 ("MacAvoy"). The three major IXCs' much-vaunted discount plans were only slightly less profitable. MacAvoy estimated that AT&T's price-cost margins on its Reach Out America plan were 97 percent of those on its standard MTS plan; MCI's margins for its Prime Time Day and Friends and Family I plans averaged 95 percent of those on its standard rates; and Sprint's margins on the Sprint Plus and Sprint Select discount plans averaged 90 percent of those on its standard MTS plan. MacAvoy, pp. 135-36. The margins on international routes were even higher than in domestic markets. By comparison with these margins, in a sample of 284 U.S. industries in 1981, the average price-cost margin was 27.5 percent. Even in the group of industries in that sample with the highest market concentration (the top four firms accounting for at least 81 percent of sales), the average price-cost margin was 33 percent. MacAvoy, pp. 164-75. These calculations preceded a substantial reduction in intrastate access charges that took effect on January 1, 1995, which the major IXCs used to increase their margins.

quickly and not lose sight of the obvious. The BOCs' affiliates will start from ground zero: they have no share of the interLATA market. After the BOCs' affiliates have entered that market, they will compete with immense, entrenched, and worldwide providers. Moreover, the BOCs' affiliates will have to depend on their lightly regulated rivals for interstate facilities (which, even when sold in bulk, will be priced well above the IXCs' cost).[52]

Thus, the BOCs' affiliates are not, in *fact*, dominant. The Commission could only presume that they *would become* dominant if not regulated *as* dominant. Such a finding could only be based on speculation. And it would not pass the flimsiest cost-benefit analysis. Implausible supposition about how the BOCs' affiliates might, at some distant future time, impose unilateral price increases on the interLATA market must be weighed against the undeniable fact that none of the BOCs' affiliates currently has any interLATA market presence, let alone market power. The IXCs are not worried about BOC market power. Dominant regulation of the BOCs' affiliates is not even designed to constrain the type of market power the IXCs allege the BOCs will have. The IXCs are worried about facing new competitors.

The Commission has a formidable arsenal of weapons to constrain the exercise of market power. Dominant regulation is only one of them. If the IXCs' direst predictions come true, and nondominant regulation of the BOCs' affiliates results (paradoxically) in anticompetitive price *increases*, dominant regulation could be re-imposed almost at a moment's notice. Therefore, as the Commission acknowledges, the real issue is whether a BOC affiliate

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[52] The Commission itself has concluded that there is "a significant excess capacity" in the interstate long distance market. Reselling this excess capacity to the BOCs' affiliates could make IXCs whole even if they lose a significant share of the retail long distance market.

could "quickly" dominate the interLATA market. *NPRM*, paras. 133, 134. No likely scenario presents itself to explain how one could.

A. The InterLATA Market Is A Single Product Market

In the *Competitive Carrier* proceeding, the FCC defined the relevant product market, for purposes of assessing the market power of domestic interexchange carriers covered by that proceeding, as "all interstate, domestic, interexchange telecommunications services" and concluded that there were no relevant submarkets.[53] Recently, in CC Docket No. 96-61, the Commission tentatively changed its position and concluded that "a narrower product market definition might provide 'a more refined analytical tool' for evaluating whether a carrier or group of carriers together possess market power." *NPRM*, para. 116. In the *NPRM*, the Commission tentatively concludes that "if we adopt the approach to product market definition outlined [in Docket 96-61], we should treat all interstate, domestic, interLATA telecommunications services as the relevant product market for purposes of determining whether the BOC affiliates have market power in the provision of interstate, domestic, interLATA services." *NPRM*, para. 119.

As the Commission acknowledges, the definition of a product market turns on whether there are sufficiently close substitutes for that product or group of products. *NPRM*, para. 118. Based on this definition, we support the Commission's tentative conclusion that the relevant product market is all interstate, domestic, interLATA telecommunications services. Telecommunications services are highly substitutable. MTS, discount plans, WATS, 800, foreign exchange service, wireless, even "carrier" access services are all available to consumers at retail to place or receive garden-variety interexchange calls. For high-volume customers, even more substitutes exist. Even if all providers conspired to "corner" the market in any of these services, the attempt would necessarily fail. Demand would quickly shift to substitutes.

B. The InterLATA Market Is Not A "Point To Point" Market

In the *NPRM*, the FCC requests comment on whether "the relevant geographic market for interstate, interexchange services should be defined as all calls from one particular location to another particular location." *NPRM*, para. 123. We disagree.

The interLATA market is not a "point to point" market. The "point to point" standard could slow new competitive entry and balkanize pricing by tempting existing carriers to challenge new entrants on every new route they propose to serve -- a tactic that was used for decades to stymie competition between airlines. More fundamentally, a "point to point" standard is not consistent with the way that consumers choose providers of telecommunications services. They *presubscribe* to carriers. Consumers sign up with an IXC to make calls to many different points, not just one. (There is one exception -- "casual" calling, *i.e.*, dialing an access code -- but this exception merely reinforces that presubscription is the rule.) The pattern of current industry pricing -- Sprint Sense; MCI Minutes; and AT&T's rate structure for calls to Canada -- bears this out. The market is more and more characterized by "postalized" price structures in which distance is irrelevant.

C. The BOCs' Affiliates Could Not Raise Prices In The InterLATA Market By Restricting Output

As the Commission notes, the essence of market power is the ability to "profitably raise and sustain prices above competitive levels." *NPRM*, para. 131. The Commission describes two scenarios under which the BOCs' affiliates might raise prices in the interLATA market:

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[53] *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor,* 95 F.C.C.2d 554, para. 13 (1983) (*Fifth Report and*

> First, a carrier may be able to raise prices by restricting its own output (which usually requires a large market share); second, a carrier may be able to raise prices by increasing its rivals' costs or by restricting its rivals' output through the carrier's control of an essential input, such as access to bottleneck facilities, that its rivals need to offer their services. *NPRM*, para. 131.

The Commission notes that in determining whether a carrier has the ability to raise price by restricting its own output, "the Commission ... has focused on certain well-established market features, including market share, supply and demand elasticity, the cost structure, size, or resources of the firm, and control of bottleneck facilities." *NPRM*, para. 133. By these criteria, the BOCs' affiliates will have no power to raise prices.

Market share. As the FCC acknowledges, for a firm to raise prices by restricting its own output "usually requires a large market share." *NPRM*, para. 130. The BOCs' interLATA affiliates have none.

Supply and Demand Elasticity. The BOCs' affiliates will enter the interstate, interLATA market with little or no transmission capacity of their own. In recently declaring AT&T to be nondominant in domestic interstate, interexchange services, the Commission observed that "there is a significant excess capacity in this market and that there are a large number of long-distance carriers, including four nationwide, facilities-based competitors, AT&T, MCI, Sprint, and WorldCom; dozens of regional facilities-based carriers; and several hundred smaller resale carriers."[54] This finding simply cannot be reconciled with declaring the BOCs' interLATA affiliates to be dominant based on supply and demand elasticities.

Order).

[54] *Bell Operating Company Provision of Out of Region Interstate, Interexchange Services,* CC Docket No. 96-21, *Notice of Proposed Rulemaking,* FCC No. 96-59, para. 8, Released February 14, 1996.

Cost structure, size, or resources of the firm. This issue was squarely addressed and resolved by §272 of the 1996 Act. The BOC affiliates will be structurally separate from the BOCs, and subject to other detailed structural and nonstructural safeguards. Arrayed against each of the BOCs' affiliates are some of the largest corporate combinations in the world.

Bottleneck facilities. The BOCs' affiliates will control no bottleneck facilities. Under §272(e), any exchange access, or any facilities, services, information concerning exchange access, they obtain from their BOCs will be on the same terms as their competitors. Long distance transport will be obtained from already-established IXCs. It was for these reasons, among others, the Commission decided that exchange telephone companies could provide interexchange service on a nondominant basis through separate affiliates.[55] That was in 1984. Twelve years have passed without any evidence of "bottleneck" abuse by independent LECs.

The 1996 Act has only strengthened the case for extending nondominant regulation to the interLATA affiliates of the BOCs. The 1996 Act imposes substantial new interconnection obligations on incumbent LECs (§251). It requires BOCs to meet a detailed competitive checklist before applying for in-region interLATA authority (§271). It imposes safeguards on the BOCs and their affiliates over and above what *Competitive Carrier* requires of independent LECs. Section 272 requires a BOC affiliate to "operate independently" from the BOC (§272(b)(1)); to maintain separate books, records, and accounts from the BOC (§272(b)(2)); to have separate officers, directors, and employees (§272(b)(3)); and to conduct all transactions with the BOC on an arm's length basis, reduced to writing and made available for public inspection (§272(b)(5)). The BOC is required to charge its affiliate "an amount for access to its telephone exchange service and exchange access that is no less than the amount [that the BOC charges] any unaffiliated interexchange carriers for such services" (§272(e)(3)). Section 272(e)(2) restricts the BOC's ability to provide "facilities, services, or information concerning its provision of exchange access to [its affiliate], unless [it makes] such facilities, services, or information ... available to other providers of interLATA services in that market on the same terms and conditions." Section 272(e)(1) prohibits a BOC from discriminating against unaffiliated carriers by delaying their requests for exchange service and exchange access. Joint marketing of the BOC affiliate's long distance service with the affiliated BOC's local service is prohibited unless competing interexchange carriers have the same ability to bundle long distance service with the BOC's local services (§272(g)). Finally, the 1996 Act gives the Commission new statutory weapons to punish anticompetitive behavior (§253, 271(d)(6)). No reasoned explanation can now support withholding competitive freedoms from the BOCs' interLATA affiliates that other LECs' interLATA affiliates have enjoyed for twelve years.

D. The BOCs' Affiliates Could Not Raise Prices In The InterLATA Market By Restricting The Output Of Their Competitors

The FCC also requests comment on whether the BOCs' affiliates could raise prices in the interLATA market by restricting the output of their competitors. The Commission suggests three different mechanisms by which BOCs might accomplish this: by improperly allocating costs (*NPRM,* para. 138); by discrimination (*NPRM,* para. 140); and by a so-called "price squeeze" (*NPRM,* para. 141).

[55] *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor,* 98 F.C.C.2d 1191, para. 6 (1984) (*Fifth Report and Order).*

An observation must be made about these scenarios at the outset. Even if they were plausible, they would not support dominant regulation of the BOC's interLATA affiliate. They all concern misbehavior by the BOC. Dominant regulation of the affiliate would do nothing to address the misbehavior of the BOC itself. It was not designed to do so. Perhaps for that reason, the Commission did not rely on this theory of market power when it granted nondominant treatment to the affiliates of independent LECs.[56]

The "bottleneck" abuse theory is also mooted by the 1996 Act, particularly §§251-52 and the Commission's new interconnection rules. The 1996 Act not only prohibits legal barriers to entry,[57] but destroys any economic advantage that would otherwise accrue to incumbents due to their existing network investments. Indeed, incumbent LECs have, in a sense, now been required to bear the opportunity costs of entry for their competitors. Incumbent LECs were required to make investments to build out their exchanges, and must meet investors' demands for a return on those investments. New entrants will not. As Prof. Jerry Hausman pointed out in his affidavit filed with USTA's Comments in CC Docket 96-98, this availability of network elements is the equivalent of a free option for new entrants, with the incumbent LEC bearing the risk of all uncertainty. It is ironic that the "bottleneck" abuse theory should continue to be alleged. With interconnection requirements, if there were any market power in the local exchange, competing providers would be able to obtain and leverage that market power themselves.

Cost Misallocation. The cost misallocation scenario ignores all regulation of the BOC and presumes the incompetence of both State and Federal regulators. But telecommunications

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[56] See *Fifth Report and Order.*

[57] See 47 U.S.C. §253. An exception is made for State or local "requirements necessary to preserve and advance universal service, protect the public safety and welfare,

regulators are not Keystone cops. The BOCs' access prices and practices have been the subject of intense scrutiny by the Commission and the IXCs at least once a year since 1983. The Commission repeatedly has given them its imprimatur, often allowing them to take effect only after extremely fine adjustments. The Commission's Part 64 rules have provided an independent check on this direct scrutiny of prices and practices. The accounting safeguards require BOCs to file, for public comment and Commission approval, cost accounting manuals that establish procedures for assigning costs to regulated and nonregulated activities based on a uniform accounting system and prescribed cost-allocation principles.[58] (These cost allocation rules tend to overallocate costs to competitive activities.) Independent auditors must review the BOCs' books of account annually and attest that their accounting methodologies and cost allocations conform with the cost accounting manuals approved by the FCC, as well as with the FCC's joint cost rules and any other regulations.[59] The FCC's auditors, in turn, review these independent audits. The FCC also uses ARMIS, an automated system, to track the BOCs' accounts over time and to compare the accounts of different BOCs, making detection of inappropriately priced transfers simple.[60] More than once the Commission has declared these rules sufficient to detect any misallocations between regulated and nonregulated activities.[61] The D.C. Circuit upheld the

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ensure the continued quality of telecommunications services, and safeguard the rights of consumers" and management of rights of way. §253 (b), (c).

[58] See *Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 LEC Safeguards*, 6 FCC Rcd 7571 (1991); *Separation of Costs of Regulated Telephone Service From Costs of Nonregulated Activities*, 2 FCC Rcd 1298 (1987).

[59] *Computer III Remand Order* at 7593; *Cost Separation Order* at 1329-33.

[60] *Computer III Remand Order* at 7593.

[61] *Computer III Remand Order*, paras. 12-13; *Telephone Company-Cable Television Cross-Ownership Rules, §§63.54-63.58,* 10 FCC Rcd 244, paras. 156, 161, 166, 169, 179-82 (1994); *Amendment of the Commission's Rules to Establish New Personal Communications Services*, 8 FCC Rcd 7700, para. 126 (1993).

Commission's cost accounting rules.[62] The California Public Utilities Commission has adopted the cost accounting rules as its own.[63]

Price cap regulation, as the Commission acknowledges, provides yet another check on misallocation. "Because price cap regulation severs the direct link between regulated costs and prices, a carrier is not able to recoup misallocated nonregulated costs by raising basic service rates, thus reducing the incentive for the BOCs to allocate nonregulated costs to regulated services."[64] Far from allowing increases in regulated rates to recover nonregulated costs, the price cap formula is designed to *reduce* inflation-adjusted access prices every year, irrespective of costs. Pacific Bell's interstate access prices have been reduced by more than half since divestiture. Our intrastate access prices are now less than half the national average.

Finally, as the Commission also acknowledges, the supposed purpose of cost misallocation -- predatory pricing -- would be impracticable:

> even if a BOC is able to allocate improperly the cost of its affiliate's interLATA services, it is questionable whether a BOC affiliate could successfully engage in predation. At least three interexchange carriers -- AT&T, MCI, and Sprint -- have nationwide or near-nationwide network facilities. These are large well-established companies with customers throughout the nation. It may be unlikely, therefore, that a BOC affiliate, whose customers presumably would be concentrated in one geographic region, could drive one or more of these companies from the market. Even if it could do so, there is a question whether the BOC affiliate would later be able to raise prices in order to recoup lost revenues. As Professor Spulber has observed, "[e]ven in the unlikely event that [a BOC affiliate] could drive one of the three large interexchange carriers into bankruptcy, the fiber-optic transmission capacity of that carrier would remain intact, ready for another firm to buy the capacity at a distress sale and immediately undercut the [affiliate's] noncompetitive prices." *NPRM*, para. 137.

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[62] *Southwestern Bell Corp. v. FCC*, 896 F.2d 1378 (D.C. Cir. 1990)
[63] *Alternative Regulatory Frameworks,* 33 C.P.U.C.2d 43 (1989).
[64] *Computer III Remand Order* at 7596.

This is unquestionable logic. As we noted above, the market share, structure, size and resources of the BOCs' affiliates are dwarfed by those of established providers. Cost misallocation could have no other object than predatory pricing. And it would be inconsistent with the Commission's finding of "substantial excess capacity" in the long distance market (above) for the Commission to hold that predatory pricing could succeed.

Discrimination. The Commission says that "[i]n addition to improper allocation of costs, a BOC potentially could use its market power in the provision of local exchange and exchange access services to the advantage of its interLATA affiliate by discriminating against the affiliate's interLATA competitors":

> For example, a BOC could provide its affiliate's interLATA competitors with poorer quality interconnection to the BOC's local network than it provides to its affiliate, or it could unnecessarily delay satisfying its competitors' requests to connect to the BOC's network. To the extent that interexchange customers believe that the BOC affiliate offers a higher quality of service, the BOC affiliate may be able to raise its interLATA rates. Moreover, even occasional disruptions of a competing carrier's services may cause customers to choose another carrier. We believe that these and other forms of discrimination may be difficult to police, particularly in situations where the level of the BOC's "cooperation" with unaffiliated interLATA carriers is difficult to quantify. *NPRM*, para. 139.

At first blush, this scenario would appear to put us in the familiar, impossible position of having to prove a negative. On further reflection, the negative itself contains the seeds of its destruction. To be effective in its aim, the discriminatory behavior cannot be "difficult to police" or "difficult to quantify." The BOC would have to degrade the quality or speed of calls so much that the customer notices. As the Department of Justice has written, "discrimination is unlikely to be effective unless it is apparent to customers. But, if it is apparent to customers, it is also likely to be apparent to regulators or competitors that could bring it to the regulators' attention."[65]

Not only must the degraded quality of the BOC's affiliate's competitors be obvious to consumers; a necessary corollary is that millions of customers must believe that the quality of the BOC's affiliate's service is better than anyone else's. Otherwise, they will not switch carriers. They will just make fewer interLATA calls, which would harm everybody, including the BOC and its affiliate. In the absence of a massive advertising campaign that touts the superior service quality of the BOC's affiliate, which rivals and regulators could hardly fail to notice, the discrimination scenario would be self-defeating.

The fact is that if such discriminatory behavior *could* happen, it would *already* have happened. In California, we have competed with IXCs for intraLATA toll since 1984.[66] Our enhanced services affiliate has competed with enhanced service providers, such as MCI's, since the 1980s. Both lines of business, according to the discrimination scenario, offered rich opportunities for us to discriminate by engineering allegedly detectable-yet-undetectable differences in the quality of service. No such complaints have ever been brought against us. It is not for lack of police. The IXCs would prosecute any such discrimination vigorously, if it were detectable enough to have a reasonable chance of success -- witness MCI's marathon challenge to the Shared Network Facilities Agreements.[67] For ONA services, the FCC itself requires the

[65] Report and Recommendations of the United States Concerning the Line-of-Business Restrictions Imposed on the Bell Operating Companies by the Modification of Final Judgment at 96, *United States v. Western Elec. Co.*, No. 82-0192 (D.D.C. Feb. 2, 1987).

[66] The interLATA corridors of NYNEX and Bell Atlantic, and the interLATA affiliates of exchange carriers such as GTE, Centel, SNET, and Rochester, should have offered similar test beds for illicit discrimination. To our knowledge, there have been no complaints of any.

[67] See *Investigation of Special Access Tariffs of LECs,* 8 FCC Rcd 1059 (1993).

filing of reports showing total orders, due dates missed, and average intervals for each category within its installation and maintenance reports.[68] Despite this abundance of data no complaints have ever been filed against us alleging illicit discrimination in favor of nonregulated affiliates.

Unjust or unreasonable discrimination by common carriers is already illegal.[69] Offending carriers are subject to damages,[70] fines,[71] forfeitures,[72] and imprisonment.[73] The 1996 Act prohibits any discrimination at all between a BOC and its affiliate "and any other entity in the provision or procurement of goods, services, facilities, and information, or in the establishment of standards,"[74] and specifically requires a BOC to "fulfill any requests from an unaffiliated entity for telephone exchange service and exchange access within a period no longer than the period in which it provides such telephone exchange service and exchange access to itself or its affiliates," among other requirements.[75] The FCC may impose penalties or revoke the in-region interLATA authority of any BOC that violates nondiscrimination safeguards.[76] The FCC is required to act on third party complaints alleging such violations within 90 days.[77]

The implausibility of the illicit discrimination scenario, the comprehensive safeguards against it that already exist, the awesome array of penalties that noncompliance would trigger,

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[68] See *Amendment of §64.702 of the Commission's Rules and Regulations (Third Computer Inquiry),* 2 FCC Rcd 3072 (1987), *modified on recon.,* 3 FCC Rcd 1150 (1988), *further modified on recon.*, 4 FCC Rcd 5927 (1989), *vacated and remanded, California v. FCC,* 905 F.2d 1217 (9th Cir. 1990); *Computer III Remand Proceedings,* 5 FCC Rcd 5242 (1990); *Bell Operating Company Safeguards*, 6 FCC Rcd 7571 (1991).

[69] See 47 U.S.C. §202(a). See also Cal. Pub. Util. Code §709.2(c)(1), and *Alternative Regulatory Frameworks,* 33 C.P.U.C.2d at 119-21.

[70] See 47 U.S.C. §206.

[71] See 47 U.S.C. §502.

[72] See 47 U.S.C. §202(c), 203(e), 503(b).

[73] See 47 U.S.C. §501.

[74] 47 U.S.C. §272(c)(1).

[75] 47 U.S.C. §272(e).

[76] See 47 U.S.C. §271(d)(6).

and its failure ever to arise even under circumstances where, if practicable, it should have arisen, eliminate it as a reason to impose dominant regulation on the BOCs' affiliates.

Price Squeezes. The Commission describes the "price squeeze" scenario as follows:

> Absent appropriate regulation, a BOC could potentially raise the price of access to all interexchange carriers, including its affiliate. This would cause competing carriers to raise their retail interLATA rates in order to remain profitable. The BOC affiliate could then capture additional market share by not raising its prices to reflect the increase in access charges. Although the BOC affiliate would report little or no profit, the BOC firm as a whole would receive higher access revenues from unaffiliated interexchange carriers and increased revenues from the affiliate's interLATA services causes [*sic*] by its increased share of interLATA traffic. If the BOC were to raise its access rates high enough, it would be impossible for the interexchange competitors to compete effectively. Thus, the entry of a BOC's affiliate into the provision of in-region, interstate, domestic, interLATA services gives the BOC an incentive to raise its price for access services in order to disadvantage its affiliate's rivals, increase its affiliate's market share, and increase the profits of the BOC overall. *NPRM*, para. 141.

"Equivalently," notes the Commission, "a BOC could fail to pass through to interexchange carriers a reduction in the cost of providing access services. Price cap regulation would not be effective in eliminating the effect of a price squeeze initiated under these circumstances." *NPRM*, para. 141, n.272.

Before we respond to this scenario, a reality check is once again in order. The scenario does not actually describe a "price squeeze." It describes a competitor willing to accept "little or no profit" in order to expand market share. That is not, by itself, anticompetitive -- just the opposite. As Prof. Hausman describes, a true price squeeze would occur only if the price

[77] *Id.*

charged by the BOC's affiliate were less than the BOC's marginal cost of access, plus the foregone contribution from that access, plus the cost to the BOC's affiliate of providing the long distance service.[78] It would be irrational for the BOC's affiliate to price below this level unless its object was predation. For reasons pointed out both by the Commission, *NPRM*, para. 137, and the Hausman Statement, para. 30, a predatory strategy would make no sense because of the excess capacity in the interLATA market. In any event, a proper imputation rule forecloses the possibility of a price squeeze. Section 272(e) contains such an imputation rule.

Even as described by the Commission, the "price squeeze" scenario is implausible. First, as the Commission notes, it can only occur "absent appropriate regulation." But there *is* appropriate regulation. Subject to price cap regulation in both jurisdictions, our overall prices are capped, so we cannot initiate a price squeeze *per se*. It is true, as the Commission intimates, that it may set the productivity factor in the price cap formula too low. *NPRM,* n.272. But it may also set it too high, conferring a windfall (by the Commission's logic, which we question below) on the BOC's affiliate's competitors. The Commission's decisions declare that price cap regulation works.[79] The D.C. Circuit has correctly observed that under price caps, "higher costs will not produce higher legal ceiling prices," so there is no "reward for shifting costs from unregulated activities into regulated ones."[80] Given these decisions, the Commission would be hard pressed, as a matter of law, to reach a decision in this case that assumes price cap regulation does not work. If price cap regulation does not work, that calls for revising it, not imposing dominant regulation on the BOC's interLATA affiliate.

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[78] Statement of Professor Jerry A. Hausman, filed with Comments of USTA in this proceeding ("Hausman Statement"), para. 31.

[79] See for example *Policy and Rules Concerning Rates for Dominant Carriers*, 4 FCC Rcd 2873, 2924 (1989).

Second, the "price squeeze" contention assumes behavior that would not, under the conditions described by the Commission, be profit-maximizing. As MacAvoy writes: "There never appears to have been a case against a firm that successfully leveraged a second monopoly from a bottleneck monopoly. Robert Bork dispelled much of the theory of bottleneck monopoly by showing that in most instances two monopolies were not better than one: A firm could get all its market returns from the first monopoly."[81] Because of the imputation rule in §272(e), the BOC's interLATA affiliate gains no cost or price advantage over its rivals when its BOC raises access prices.[82] Thus, contrary to what the Commission suggests, the BOC's interLATA affiliate would not automatically increase market share. The BOC's affiliate and its competitors have the same incentives to respond to an access price increase: to raise prices and preserve marginal profit but risk losing market share; or keep prices steady, reduce marginal profit, and perhaps increase market share. For its part, the BOC has the same incentive (if not the ability) to raise (or, as the Commission suggests, to not reduce) access prices whether it has an interLATA affiliate or not.

The so-called "price squeeze" allegation is really just a repackaging of the theory that incumbent LECs should never be allowed to profit from the sale of any inputs to competitors. This would be bad economics. Because the BOC's necessary joint and common costs would not be recovered, such a rule would immediately cause inefficiency. Assume that a BOC is forced to

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[80] *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174, 178 (D.C. Cir. 1993).

[81] MacAvoy, p. 195 (citing Robert H. Bork, *The Antitrust Paradox: A Policy At War With Itself*, Basic Books, 1978, pp. 372-73).

[82] The CPUC has an imputation standard that is similar in its objective to the imputation rule of §272(e)(3). Pacific Bell is required to impute to its own operations the contribution that competitors would have to pay for the same services. *Alternative Regulatory Frameworks for Local Exchange Carriers*, 56 C.P.U.C.2d at pp. 117, 212, 216-18 (1994).

provide an essential input, such as a minute of access, to an unaffiliated IXC at the BOC's incremental cost of $.01. Assume also that the BOC's interLATA affiliate and the unaffiliated IXC are equally efficient, so that their costs in addition to access are $.02. The break-even price for the unaffiliated IXC would then be $.03. But the BOC would not break-even at this price, because its joint and common costs would not be recovered.

As Prof. Hausman points out in his Statement, BOCs, unlike IXCs, have an incentive to lower prices in both the upstream access market (to grow the downstream long distance market) and the downstream long distance market (to grow their market share). Hausman Statement, para. 24. In a recent paper, using game theory to determine the profit-maximizing level of access charges for BOCs who enter the interLATA market, two economists reached the same conclusion. Moreover, they opined that BOCs would have an incentive to discriminate only if access charges were priced at or below marginal cost. Since reducing access charges to marginal cost is what IXCs advocate, it calls into question whether IXCs really believe, as they allege, that BOCs have the practical ability to discriminate in favor of their affiliates.[83]

E. If Incumbent LECs Could Leverage Local Exchange Market Power Into Other Markets, They Would Already Have Done So

There is already a wealth of empirical evidence that incumbent LECs cannot leverage local exchange market power into other markets, such as interLATA. For many years the BOCs and other incumbent LECs have been engaged in competitive lines of business that rely on inputs from the local exchange. The provision of interLATA services by affiliates of independent LECs is one example. The Commission suggests this may be distinguishable, saying, the "BOCs' local exchange and exchange access bottleneck facilities extend over much larger geographic areas than the independent LECs' facilities." *NPRM*, para. 147. But this is not always true. Pacific Bell's and Nevada Bell's combined service areas are easily exceeded in size by those of GTE-Contel and United-Centel (whose interLATA affiliate is Sprint). Nothing but the historical accident of the MFJ distinguishes these independent LECs from the BOCs. The BOCs are not necessarily predominant even in the states they are named after. Nevada Bell, for example, serves only about 30 percent of the access lines in Nevada.

As the Commission also recognizes, the BOCs have provided enhanced services on a semi-integrated basis for years. *NPRM*, para. 145. Of enhanced services provided by BOCs and interstate, interexchange services provided by independent LECs, the Commission says that its "experience to date ... has not disclosed a systematic pattern of anticompetitive abuses by independent LECs or the BOCs that would indicate that our safeguards are ineffective." *NPRM*, para. 146. This is correct but understated. These markets are quite competitive.

There are other examples. As Prof. Hausman notes in his Statement, BOCs have provided cellular service through separate affiliates without any evidence of discrimination. In fact, Hausman found, cellular prices are lower where an in-region BOC provides the B block cellular service. Hausman Statement, para. 28. Sales of CPE and Centrex (which is usually provided on a fully integrated basis), notes Hausman, demonstrate the same point. Ironically, one of the objections that competitors made to lifting structural separation requirements governing the BOCs' provision of CPE is now echoed by the Commission itself: "because the BOCs are likely to offer local exchange and interLATA services as integrated offerings to end users, they may have a greater incentive and ability to use their control over local bottlenecks to

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[83] See David S. Sibley and Dennis L. Weisman, "Competitive Incentives of Vertically Integrated Local Exchange Carriers," November, 1995.

obtain anticompetitive advantages." *NPRM*, para. 147. In the case of CPE, the Commission correctly decided that joint marketing requirements -- the equivalent of §251's requirement that incumbent LECs resell exchange services to competitors -- mooted this objection.[84]

Pacific Bell, like many other LECs, has provided intrastate intraLATA toll in competition with the major IXCs since 1984. The amount of traffic is significant -- about one-third of all intraLATA toll calls nationwide are placed within California.[85] We provide intraLATA toll on a fully integrated basis. The CPUC has addressed competitive issues through imputation rules and other nonstructural safeguards. Though in most cases IXCs were not permitted to advertise their intraLATA toll services until January 1, 1995, our share of the intraLATA toll market has steadily diminished. A mid-1995 study of business calling patterns indicated that Pacific Bell carried only 56% of intraLATA toll minutes (and business accounts for about 60% of all intraLATA toll calls). Since many intraLATA toll minutes captured by IXCs are not switched, but are carried to services like AT&T's MEGACOM over dedicated trunks, the actual loss is not directly measurable and may be greater.

Two other BOCs, Bell Atlantic and NYNEX, have provided interLATA services in "corridors" since divestiture.[86] Judge Greene theorized that permitting these BOCs to offer this interLATA service would give them the same incentive to impede competition as they would have in the broader interexchange market.[87] These services are also provided on a fully integrated basis. Yet there is no evidence of anticompetitive conduct. NYNEX and Bell Atlantic

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[84] See *Furnishing of Customer Premises Equipment by the Bell Operating Companies and the Independent Telephone Companies*, 2 FCC Rcd 143 (1987), *modified on recon.*, 3 FCC Rcd 22 (1988).

[85] *FCC Statistics of Common Carriers*, 1993-94 Edition, Table 2.6.

[86] See *United States v. Western Elec. Co., Inc.*, 569 F. Supp. 990, 1018-19, 1021-23 (D.D.C. 1983).

made equal access conversions as fast or faster than other BOCs. They do not charge higher prices for local exchange access than the average BOC. And they have not captured dominant, or even significant, shares of this corridor traffic. Last year Bell Atlantic estimated that its share of the interLATA corridor calls was less than twenty percent, even though its rates were 20 to 30 percent below AT&T's, MCI's, and Sprint's.[88]

F. Dominant Regulation Of The BOCs' Affiliates Would Make The InterLATA Market No More Competitive Than It Is Today, Frustrating The Intent Of Congress

For reasons we have shown above, dominant regulation of the BOCs' affiliates would not advance any legitimate purpose. It would, in fact, frustrate the intention of Congress, which was to make the long distance market more competitive.

The Commission is aware of the anticompetitive effect of dominant regulation. When it decided that certain IXCs would be treated as nondominant, it said:

> Tariff posting ... provides an excellent mechanism for inducing noncompetitive pricing. Since all price reductions are public, they can be quickly matched by competitors. This reduces the incentive to engage in price cutting. In these circumstances firms may be able to charge prices higher than could be sustained in an unregulated market. Thus, regulated competition all too often becomes cartel management.[89]

This being the case, it makes especially little sense, as the Supreme Court has recognized, to "require filing by the dominant carrier, the firm most likely to be a price leader."[90] When the BOCs' affiliates filed their dominant tariffs, IXCs would clamor their prices were too low.

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[87] 569 F. Supp. at 1018, n.142.

[88] See *Petition to Regulate Bell Atlantic as a Nondominant Provider of Interstate InterLATA Corridor Service, Declaration of Robert W. Crandall*, pp. 65, 68.

[89] *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor,* 84 F.C.C.2d 445, para. 26 (1981).